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Report to Commander, U.S. Air Force Ballistic Missile Office

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March 1988

CONTRACT PRICING

Overpricing of Peacekeeper Missile Subcontracts

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United States
General Accounting Office

Los Angeles Regional Office

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350 South Figueroa Street
Suite 1010
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B-219741

March 28, 1988

Brigadier General Edward P. Barry, Jr.
Commander, Ballistic Missile Office
Norton Air Force Base, CA 92409-6468

Dear General Barry:

We have completed a review of the pricing of major subcontracts under prime contracts FO4704-84-C-0006 and FO4704-85-C-0023 awarded to Hercules, Inc., Magna, Utah, for Peacekeeper Missile Stage III motors, by the Ballistic Missile Office (BMO). Our objective was to determine whether Hercules complied with the Truth in Negotiations Act (Public Law 87-653) in ensuring that subcontract cost estimates included in the prime contract prices were based on accurate, complete, and current cost or pricing data as of the completion of prime contract negotiations.

Target prices of contract -0006 and -0023 were overstated by $995,353 and $176,308, respectively, including overhead and profit, because Hercules did not ensure that proposed subcontract prices for thrust vector actuators obtained from HR Textron, Incorporated, Valencia, California, were based on accurate, complete, and current cost or pricing data. In particular, we found overstatements in material cost estimates, escalation factors, and direct labor and indirect expense rates.

In addition, we do not believe that Hercules evaluated Textron price proposals in an adequate and timely manner as required by applicable procurement regulations. Hercules completed evaluations of Textron proposals after the prime contracts were negotiated, and used the results to negotiate substantially lower prices with Textron than those achieved by the BMO contracting officer using estimated reduction factors.

Hercules agreed that small amounts of material prices were overstated, but did not believe that escalation factors or direct labor and indirect expense rates were overstated. In addition, Hercules stated that it complied with the requirement for evaluating subcontract price proposals.

We do not agree with Hercules' position on material escalation, direct labor and indirect expense rates, or subcontract proposal evaluations. BMO officials agreed to pursue recovery of the overstated material prices

and to contact the cognizant contract administration office to obtain documents and recommendations regarding the escalation factors and direct labor and indirect expense rates. BMO officials also agreed that Hercules should have made timely subcontract proposal evaluations and that BMO personnel could have done more to obtain the evaluations. (See app. I.)

We believe the information in this report provides a basis for you to initiate action to recover the overstated prices from Hercules, and we recommend that you take such action. We would appreciate being informed of any actions taken on this matter. If you or your staff need additional information, please call me or Mr. Ronald A. Bononi at (213) 894-3813.

Copies of this report are being sent to the Vice President, Finance, HR Textron, Incorporated, Valencia, California; the Vice President, Controls and Administration, Hercules Aerospace Company, Aerospace Products Group, Magna, Utah; the Department of Defense, Office of the Inspector General, Washington, D.C.; the Secretary of the Air Force; the Regional Director, Defense Contract Audit Agency, San Francisco, California; and the Commander, Defense Contract Administration Services Region, Los Angeles, California. Copies will also be made available to others upon request.

Sincerely yours,

George E Grant

George E. Grant
Regional Manager

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Abbreviations

BMO	Ballistic Missile Office
DCAA	Defense Contract Audit Agency
DCAS	Defense Contract Administration Services
TVA	thrust vector actuator

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Overpricing of Peacekeeper Missile Subcontracts for Thrust Vector Actuators

Background

The Truth in Negotiations Act, Public Law 87-653, requires that, with certain exceptions, contractors submit cost or pricing data in support of proposed prices for noncompetitive contracts. The act also requires contractors to certify that data submitted are accurate, complete, and current. The contract includes a clause that gives the government a right to a price reduction if it is determined that the price was overstated because the data submitted were not accurate, complete, or current.

Applicable procurement regulations state that the prime contractor is responsible for the review and evaluation of prospective subcontract cost or pricing data. Further, the regulations provide that the contractor is responsible for submission of the evaluation results to the government contracting officer as part of the prime contractor's cost or pricing data submission.

The Ballistic Missile Office (BMO) awarded fixed-price incentive contract F04704-84-C-0006 to Hercules for the first production buy of stage III motors at a target price of $99,520,000. The contract price proposal included a Hercules estimate of $9,317,004 for thrust vector actuators (TVA)[1] to be acquired from Textron. Hercules had a Textron subcontract proposal dated September 2, 1983, to support its estimate. Prime contract negotiations were completed on December 21, 1983. Hercules executed a Certificate of Current Cost or Pricing Data on December 21, 1983, and certified that the data were accurate, complete, and current as of that date. Hercules subsequently negotiated with Textron a subcontract price of $6,500,000 on May 3, 1984, which was about $2.8 million less than the estimate.

BMO also awarded Hercules fixed-price incentive contract F04704-85-C-0023 for the second production buy of stage III motors at a target price of $82,977,404, excluding warranty. Hercules included a cost estimate of $6,087,353 in its proposal to BMO for TVAs. Hercules' estimate was based on a Textron proposal dated August 27, 1984. Prime contract negotiations were completed on December 21, 1984. Hercules executed a Certificate of Current Cost or Pricing Data on February 5, 1985, and certified that the data were accurate, complete, and current as of December 21, 1984. Hercules subsequently negotiated with Textron, a subcontract price of $4,350,000 on November 21, 1985, which was about $1.7 million less than the estimate.

[1] A device used to change the direction of thrust and thereby aid guidance of the missile to its ultimate target.

Noncompliance With Public Law 87-653 Resulted in Overstated Subcontract Price in Contract F04704-84-C-0006

Hercules did not ensure that subcontract cost or pricing data submitted by Textron was accurate, complete, or current as of the date of prime contract negotiations. As a result, the contract target price was overstated by $995,353, including overhead and profit as shown in table I.1 and discussed in the following section.

Table I.1: Overstated Textron Cost Estimate

	Amount
Overstated material prices	$9,200
Escalation of material and interdivision costs	210,665
Material price increases for quantity differences	21,035
Noncurrent direct labor and indirect expense rates	199,800
Total	**$440,700**
Textron overhead and profit	188,516
Hercules overhead and profit	366,137
Total	**$995,353**

Overstated Material Prices

The Textron subcontract proposal included an estimate of $3,341,031 for hydraulic power units. The hardware portion of the estimate was $1,591,875, or $63,675 each for the 25-unit requirement based on proposals from a second-tier subcontractor dated July 28 and September 1, 1983. The latter proposal included prices of $63,675 and $63,307 for 23 and 25 units, respectively. Hercules did not know of the lower unit prices for the larger quantity. The unit price difference resulted in a $9,200 overstatement.

After prime contract negotiations, Textron negotiated lower prices with the second-tier subcontractor and disclosed the results to Hercules.

Hercules agreed that material prices were overstated by $9,200. BMO agreed to pursue recovery of this amount.

Escalation of Material and Interdivision Costs

The Textron proposal included 10 and 15 percent escalation factors applied to material and interdivision cost estimates. Table I.2 summarizes this proposed escalation.

Table I.2: Proposed Escalation

Item	Proposed material	Annual escalation percent	3-year compounded escalation percent	Proposed escalation
Servoactuator	$229,174	15	52	$119,371
TVA subsystem	155,891	10	33	51,600
Servovalve (interdivisicn)	147,821	15	52	76,996
Total	**$532,886**			**$247,967**

Textron escalated the material cost estimates annually for 3 years to essentially cover the anticipated performance period of the subcontract—April 1984 through November 1986. Scheduled deliveries of TVAs to Hercules were from February 1986 to December 1986.

Escalation of the servoactuator, TVA subsystem, and servovalve interdivision cost estimates were overstated by $210,665 because the Textron proposal included escalation factors of 10 and 15 percent, which exceeded the Textron pricing department's latest November 1, 1983, escalation rate of 7 percent. Textron based the lower rate on the Industrial Commodities Producer Price Index. Textron did not disclose the lower rate to Hercules or to the BMO contracting officer. Furthermore, Hercules did not evaluate Textron's proposal or request more current pricing information before completing prime contract negotiations. In addition, Textron applied the higher escalation rates for a 3-year period that anticipated material price increases well beyond the time Textron would need to place orders with vendors to meet delivery schedules.

Table I.3 provides a range of material escalation estimates based on various assumptions of elapsed time from expiration of vendor price quotations to anticipated placement of orders. For our review, we assumed a 1-year escalation at 7 percent, or $37,302, would have provided a reasonable estimate of material escalation. This estimate was $210,665 less than the amount proposed by Textron.

Table I.3: Material Escalation Estimates

Proposed by Textron at 10 and 15 percent for 3 year period	6 months		12 months		15 months	
	Estimated	Questioned	Estimated	Questioned	Estimated	Questioned
$247,967	$18,651	$229 316	$37,302	$210,665	$46,627	$201,340

Textron generally purchased servoactuator and TVA subsystem material at prices 7.8 percent higher than the initial vendor quotations when purchase orders were placed 11 to 15 months after prime contract negotiations. The experienced escalation was far less than the 52- and 33-percent compounded rates proposed. Also, Textron deleted 1 of the 3 years of proposed escalation in a revised proposal submitted to Hercules after prime contract negotiations.

Hercules and Textron believe the proposed escalation was appropriate. Hercules stated that since the vendor quoted prices were valid for only 60 to 90 days, they were escalated to the performance period of the subcontract. Textron likewise stated that the higher proposed rates were appropriate because the price quotations were firm for only a short period of time, and the subcontracts would be awarded after the expiration dates. They also contended that the use of higher rates was appropriate because the Peacekeeper Missile Program represented greater technical and price risks due to the use of different and more complex hardware, new vendors, and fluctuating program schedules. Hercules maintained that BMO was aware of the escalation rates questioned and discussed them at their fact-finding meetings.

We do not agree with these comments because (1) the proposed rates of 10 and 15 percent were higher than Textron's most current escalation rate that Hercules did not discover and disclose to the government and (2) the rates used were compounded for an unreasonable period of time — through completion of subcontract performance instead of the estimated time needed to award vendor contracts.

Actions Textron and Hercules took after prime contract negotiations confirm the inappropriate escalation of material. Hercules' in-depth cost-analysis report on Textron was based on the lower recommended rates of 5.2 percent and 6.7 percent for 1984 and 1985, respectively. Our review of BMO contract and pricing files disclosed that during the proposal evaluation, BMO raised a question concerning the 15 percent servoactuator material escalation. However, neither the substance of the question nor its disposition could be found in the files.

BMO told us it would contact the cognizant contract administration office to obtain documents and recommendations about this matter.

Material Price Increases for Quantity Differences

Textron's proposed material prices for the servoactuator, TVA subsystem, and servovalve included increases to compensate for anticipated higher unit prices to be paid for smaller hardware quantities. Table I.4 summarizes the material price increase.

Table I.4: Material Price Increase

Item	Required quantity	Base amount proposed	Percent increase	Total proposed
Servoactuator	50	$348,545	2.8	$358,305
TVA subsystem	25	207,495	2.4	212,475
Servovalve (interdivision)	50	224,817	2.8	231,112
Total		**$780,857**		**$801,892**

The proposed material costs were based on vendor quotations for 50 or 25 units. The 2.4- to 2.8-percent increase represents higher unit prices anticipated by Textron for purchasing minimum quantity requirements of 46 servoactuators and servovalves, and 23 TVA subsystems. Since Textron required the higher quantities (50/25) for subcontract performance and used them in the priced list of material, the price increases were not warranted. The overpriced material amounted to $21,035.

Textron did not include the increases in a revised proposal submitted to Hercules after prime contract negotiations.

Hercules agreed that material prices were overstated by $21,035. BMO agreed to pursue recovery of this amount.

Noncurrent Direct Labor and Indirect Expense Rates

The Textron price proposal included direct labor and indirect expenses based on bid rate[2] proposals submitted to the Defense Contract Administration Services (DCAS) on June 22 and July 15, 1983, respectively. On November 4, 1983, Textron and DCAS initiated direct labor bid rate negotiations. Textron incorporated the generally lower negotiated labor rates in its bid rate schedule on November 23, 1983. On December 8, 1983, DCAS accepted the bid rate schedule as reflecting the results of negotiations.

On November 22, 1983, Textron and DCAS also negotiated lower indirect expense rates than were proposed to Hercules. Textron approved the

[2]A rate mutually agreed to by buyer and seller for administrative convenience in pricing contract proposals under specified conditions and for a specific future period, usually a year.

use of the negotiated indirect expense rates for bidding purposes on November 23, 1983, before completing prime contract negotiations.

Hercules did not know of the results of the lower bid rate negotiations and therefore did not disclose them to the BMO contracting officer. Accordingly, Textron's proposed direct labor and indirect expenses were overstated by $199,800.

Textron included the lower negotiated rates in a revised proposal submitted to Hercules after prime contract negotiations.

Hercules stated that it had no record of rate changes at Textron before prime contract negotiations. We do not believe that lack of knowledge of the lower rates relieves Hercules of the responsibility for ensuring that Textron cost estimates were based on accurate, complete, and current cost or pricing data.

BMO stated that it would contact the cognizant contract administration office to obtain documents and recommendations about this matter.

Inadequate Subcontract Price Proposal Evaluation

Hercules' submission of cost or pricing data to the BMO contracting officer in support of proposed prices was not complete because it did not include an adequate evaluation of the Textron proposal. The Federal Acquisition Regulation 15.806(a) provides that prime contractors and higher-tier subcontractors are responsible for the review and evaluation of prospective subcontract cost or pricing data, and for submission of the results to the contracting officer as part of the prime contractor's cost or pricing data submission.

Hercules completed a preliminary cost-analysis report on September 20, 1983, before prime contract negotiations. The report basically consisted of a discussion of proposed costs because Hercules had not conducted any fact-finding or cost analysis at Textron. The report stated that an in-depth evaluation was not possible at the time, nor did it contain questioned costs. The report noted the need for Textron to do a detailed cost analysis of the second-tier subcontract proposal for hydraulic power units and to evaluate proposed material and escalation factors before subcontract negotiations. It also stated that Textron's labor, overhead, and general and administrative expense rates had not been approved and that a government audit was needed to validate the rates.

Hercules requested a Defense Contract Audit Agency (DCAA) review of rates and factors on December 6, 1983. The DCAA issued a report on January 12, 1984, after prime contract negotiations. Had Hercules requested a review earlier in the negotiations it would have known that DCAA had already issued reports on Textron's proposed indirect expense and direct labor rates on September 2 and July 26, 1983, respectively. DCAA generally recommended lower rates than those proposed to Hercules. Furthermore, the results of rate negotiations were available on November 23, 1983, before completion of prime contract negotiations.

Hercules completed an in-depth cost analysis of a Textron revised price proposal on March 13, 1984, after prime contract negotiations. The revised proposal of $8,456,528 was substantially lower than the initial proposal of $9,317,004. Hercules questioned about 50 percent of the 34,675 proposed direct labor hours, or $333,287. The Hercules cost analyst stated that proposed engineering and project management labor was already covered in the follow-on full-scale engineering development contract whose performance period overlapped that of contract -0006 and was therefore excess. Labor costs, including overhead and profit, amounted to $1,147,975 of the $1,576,697 questioned in the cost-analysis report. Hercules also questioned the proposed 10 and 15 percent annual escalation rates on the basis of lower forecast rates of 5.2 and 6.7 percent for 1984 and 1985, respectively.

Textron included a second-tier subcontract proposal of $3,341,031 for hydraulic power units in its proposal to Hercules. At the time of prime contract negotiations, Textron had not completed an evaluation of the proposal. Textron requested a government evaluation of the proposal on August 17, 1983, because the second-tier subcontractor denied Textron access to pertinent records. The evaluation was canceled on November 15, 1983, because the second-tier subcontractor did not provide adequate support for proposed costs. Textron again requested the evaluation on December 16, 1983, and DCAS completed it on January 12, 1984. DCAS questioned $1,146,997, a significant amount of which was in proposed direct labor hours. Textron used the evaluation results to negotiate a price of $2,625,000, or $716,031 less than the second-tier subcontract estimate in the proposal to BMO.

Hercules used its March 13, 1984, cost analysis and the Textron negotiation results with the second-tier subcontractor to arrive at a $6,500,000 subcontract price for TVA systems on May 3, 1984. The price was $2,817,004 less than the cost estimate included in the proposal to BMO.

To save time, the Air Force contracting officer used a 12.42-percent estimated reduction factor instead of cost analysis in establishing a negotiation objective for the Textron cost estimate. The negotiation reduction of $1,157,172 achieved by the Air Force contracting officer was less than the costs questioned by Hercules in the Textron proposal and by DCAS in the second-tier subcontract proposal. The subcontract price negotiated by Hercules with Textron after prime contract negotiations ($6,500,000) was $1,659,832 lower than the negotiation objective achieved by BMO.

Had the evaluations of the Textron and second-tier subcontract proposals been completed and provided to the BMO contracting officer before prime contract negotiations, BMO may have achieved a substantially lower negotiation objective.

Hercules believes it complied with the Federal Acquisition Regulation requirement for subcontract proposal evaluation in preparing the preliminary cost analysis on September 20, 1983, and giving it to BMO. Hercules stated that the analysis was made within the time allotted by BMO, which did not permit an in-depth study. Textron stated that it promptly commenced its evaluation of the second-tier subcontractor's proposal.

We do not agree with the thrust of Hercules' comments. The prime contractor had sufficient time from the date of the Textron proposal in early September, to the completion of negotiations in late December, to make an in-depth evaluation. Late completion of the second-tier subcontract proposal evaluation was not Textron's fault.

BMO agreed that Hercules could have accomplished more in-depth analysis earlier, and that BMO personnel could have done more to obtain the evaluation. BMO believes improvement has been made in this area, but that additional attention may be necessary.

Noncompliance With Public Law 87-653 Resulted in Overstated Subcontract Price in Contract F04704-85-C-0023

Hercules did not ensure that the subcontract cost or pricing data submitted by Textron was accurate, complete, or current as of the date of prime contract negotiations for the second production buy. As a result, the contract target price was overstated by $176,308, including overhead and profit as shown in table I.5.

Table I.5: Overstated Textron Cost Estimate

	Amount
Overstated material prices	$4,439
Escalation of material costs	45,438
Total	**$49,877**
Textron overhead and profit	61,430
Hercules overhead and profit	65,001
Total	**$176,308**

Overstated Material Prices

The Textron proposal included material cost estimates for the TVA subsystem and the servoactuator. Our review of TVA subsystem material costs disclosed that 18 items amounting to $4,439 were duplicated in the servoactuator cost estimate.

Textron corrected the duplication in its revised price proposals submitted to Hercules after prime contract negotiations.

Hercules agreed that material prices were overstated by $4,439. BMO agreed to pursue recovery of this amount.

Escalation of Material Costs

Textron escalated servoactuator material cost estimates amounting to $174,090 by $57,624 based on a 10-percent annual escalation factor for 3 years, or 33 percent compounded to essentially cover the anticipated performance period of the subcontract—April 1985 through October 1987. Scheduled deliveries of TVAs were from November 1986 to October 1987.

Escalation of the servoactuator cost estimate was overstated by $45,438 because the Textron proposal included escalation at 10 percent, which exceeded the Textron pricing department's latest escalation rate of 7 percent. Textron based the lower rate on the Industrial Commodities Producer Price Index. Textron did not disclose the lower rate to Hercules or to the BMO contracting officer. Hercules did not evaluate Textron's proposal or request more current pricing information before completing prime contract negotiations. In addition, Textron applied the higher escalation rates for a 3-year period that anticipated material price increases well beyond the time Textron would need to place orders with vendors to meet delivery schedule.

As with contract -0006, we assumed that a 1-year escalation at 7 percent, or $12,186, would have provided a reasonable estimate of material escalation. This estimate was $45,438 less than the amount proposed by Textron.

We found that Textron generally purchased servoactuator material at about 2 percent higher than the initial vendor quoted prices when purchase orders were placed 10 to 15 months after prime contract negotiations. The experienced escalation was far less than the 33 percent compounded proposed rate. Also, Textron deleted 1 of the 3 years of proposed escalation in a revised proposal submitted to Hercules after prime contract negotiations.

Hercules, Textron, and BMO comments on this matter were the same as on contract -0006. We do not agree with the Hercules and Textron comments for the previously stated reasons. In addition, their actions after prime contract negotiations confirm the inappropriate escalation of material. For example, Textron deleted 1 of the 3 years of proposed escalation, and the Hercules in-depth cost-analysis report questioned significant amounts of escalation on the basis of lower recommended rates of 0.6 and 1.7 percent for 1985 and 1986, respectively. The BMO contract and pricing files contained no evidence of questions raised regarding the propriety of material escalation.

Inadequate Subcontract Price Proposal Evaluation

As with contract -0006, Hercules' submission of cost or pricing data to the BMO contracting officer was not complete because Hercules did not include an adequate evaluation of the Textron proposal before prime contract negotiations.

Hercules completed preliminary cost and price analysis reports on October 5 and November 12, 1984, before prime contract negotiations. The latter report basically contained a comparison of proposal costs with the amounts proposed and negotiated for the prior production buy. The earlier report stated that an in-depth evaluation was not possible at the time. It also recognized the same concerns in the cost-analysis report for contract -0006 regarding the need to evaluate the second-tier subcontract proposal, along with material, escalation, and labor and indirect expense rates in the Textron proposal. The reports contained no questioned costs.

Hercules made an in-depth cost analysis of a Textron revised proposal on November 11, 1985, after prime contract negotiations. The revised

proposal of $5,093,323 was substantially lower than the initial proposal of $5,910,528. Hercules questioned $867,980, a significant amount of which was in direct labor hours and associated indirect expenses. The basis for the questioned labor hours was the same as for contract -0006. Textron used a lower 5-percent material escalation rate in its revised proposal to Hercules, and excluded escalation for a 1-year period (1987). Hercules questioned the proposed rate on the basis of lower forecast rates of 0.6 and 1.7 percent for 1985 and 1986, respectively.

Textron included a second-tier subcontract proposal of $2,110,252 for hydraulic power units in its proposal to Hercules. As with contract -0006, Textron had not completed an evaluation before prime contract negotiations. Subsequently, Textron obtained DCAS technical and price/cost-analysis reports dated April 30 and May 29, 1985, respectively. The evaluations were not provided earlier because Textron asked the second-tier subcontractor to recalculate its prices using more current historical cost data. DCAS questioned $613,859, principally in proposed direct labor hours. Textron used the evaluation results to negotiate a price of $1,650,000, or $460,252, less than the second-tier subcontract estimate in the proposal to BMO.

Hercules used its November 11, 1985, cost analysis and the Textron negotiation results with the second-tier subcontractor to arrive at a $4,350,000 subcontract price for TVA systems on November 21, 1985. The price was about $1,737,353 less than the estimate included in the proposal to BMO. To save time, the Air Force contracting officer used a 10-percent estimated reduction factor instead of cost analysis in establishing a negotiation objective for the Textron estimate. The negotiation reduction of $608,735 achieved by the Air Force contracting officer was substantially smaller than the costs questioned by Hercules in the Textron proposal and by DCAS in the second-tier subcontract proposal. The subcontract price negotiated by Hercules with Textron after prime contract negotiations ($4,350,000) was $1,128,618 lower than the negotiation objective achieved by BMO.

Had the evaluations of the Textron and second-tier subcontract proposals been completed and provided to the BMO contracting officer before prime contract negotiations, BMO may have achieved a substantially lower negotiation objective.

As with contract -0006, Hercules believes it complied with the Federal Acquisition Regulation requirement for subcontract proposal evaluation

and performed an adequate evaluation. We do not agree, because Hercules had enough time from the date of the Textron proposal in late August, to the completion of negotiations in late December, to make an in-depth evaluation. BMO comments on this matter were the same as those it made on contract -0006.

Objective, Scope, and Methodology

Our objective was to determine whether Hercules complied with Public Law 87-653 in ensuring that subcontract cost estimates in prime contract prices were based on accurate, complete, and current cost or pricing data, and whether fair and reasonable prices were negotiated.

We performed our review at HR Textron, Inc., Valencia, California; Hercules Aerospace Company, Magna, Utah; DCAS, and DCAA, Van Nuys, California; and the BMO, Norton Air Force Base, California.

Our audit work included reviewing Textron price proposals and supporting documents, purchasing file documents, such as vendor price proposals and quotations, purchase orders, proposal evaluations, and negotiation memorandums. We also reviewed Hercules and BMO contract file documents, such as price proposals, cost analyses and proposal evaluation reports, and negotiation memorandums. We discussed the results of our review with Textron and Hercules representatives, BMO contracting officials, and DCAS and DCAA representatives. We performed our review in accordance with generally accepted government auditing standards from October 1986 through April 1987.

*U.S. G.P.O. 1988-201-749:80033

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